Schweizerische Eidgenossenschaft
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EMBASSY OF SWITZERLAND IN BEIJING

CH@WORLD: **A754**

Swiss representation: **Beijing**	Ref.: 512.0-2 / BZD/FRIKA/SETMI/HGC/MAQ
Country: **China**	Last Update: June 2014

Economic report: China

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Executive Summary

Key Messages

- *In May this year, the World Bank issued a report indicating that by end 2014, China's economy will be the world's largest in terms of purchasing power parity (PPP).*

- *The first quarter of 2014 has brought the expected slowdown of the Chinese economy. GDP growth in Q1 slowed from 7.7%YoY in Q4 2013 to 7.4%YoY. China's headline CPI inflation in March was slightly higher (2.4%YoY) than in February (2%YoY), while the PPI in March contracted by 2.3%YoY.*

- *Official unemployment at year end 2013 stood at 4.1%, and despite the obvious overall slowdown, the government announced that in 2013, a total of 13.1 million new urban jobs were created.*

- *Particularly fixed asset investments, a hitherto major contributor to the economic performance, has experienced its weakest performance since 2002.*

- *The government took action when it announced on April 2nd a mini-stimulus package that should stimulate small businesses and innovative industries as well as consumption.*

- *While the biggest risk for 2014 is expected to come from the property sector, economists expect GDP to grow by 7.4% in 2014, the weakest annual expansion since 1990.*

- *From a political point of view, the conditions for economic reforms have improved substantially since the leadership change. President XI with his anti-corruption and mass-line campaigns extremely quickly managed to consolidate his power and keep his adversaries and vested interests opposing reform in check.*

- *In the 2013 Central Economic Work Conference (CEWC) the main focus were development and reform activities. This time, the six major tasks identified for 2014 were: Guarantee national food safety, vigorously adjust industrial structure and reduce industrial overcapacity, Prevent and control local government debt risk, Promote coordinated regional development, Improve and guarantee people's livelihoods, and Promote further opening up.*

- *If the Chinese government is to be believed, Urbanization will be the main driver of the country's economic growth that cannot rely any longer on exports and investments alone.*

- *Arguably for the first time, the market was taken by surprise by the central bank which let the Yuan slide starting February 18 from RMB 6.06 to RMB 6.145 within a fortnight.*

- *The visible slowdown of the property activity since the beginning of the year does not come unexpected given the strong rebound in the years 2012 and 2013.*

- *China has in 2013 overtaken the US as largest goods trader (total US trade volume USD 3.88 trillion1) and claimed back the position that the middle kingdom arguably had in the late Qing Dynasty.*

- *China is the world's second largest economy after the United States and Switzerland's third most important foreign trading partner.*

- *After the internal procedures on both sides have been completed, the bilateral Free Trade Agreement signed between the two countries on 6 July 2013 will enter into force as of 1st July 2014. This is the first comprehensive Free Trade Agreement China has signed with a developed and diverse European economy.*

1 Appreciation of the economic situation

In May this year, the World Bank issued a report indicating that **by end 2014, China's economy will be the world's largest in terms of purchasing power parity (PPP[1])**[2]. While there was a lot of controversy about the significance of this (particularly the many flaws of comparing two dissimilar economies like the US and China[3]), China has been largely silent and even tried to prevent the report from being published. The country is known to be extremely wary of such international leadership roles and does not wish to be subject to even more international pressure and responsibility. Besides, the rationale is that on per capita basis, China is still a very poor country, ranking only 99th in PPP terms compared with a 12th rank of the US. At the same time, shifting bad debt off the balance sheets of banks means that the Chinese GDP does not or only insufficiently account for incurred losses and as such, GDP is understood to be overstated, only to be adjusted over the course of the coming years.

The **first quarter of 2014 has brought the expected slowdown of the Chinese economy.** GDP growth in Q1 slowed from 7.7%YoY in Q4 2013 to 7.4%YoY. Quarter-over-quarter, GDP growth was at 1.4% (5.7% annualized), also slower than the Q4 2013 figures (1.7%, annualized 7%), both developments of which are illustrated below (Figure 1). This is to be understood against the backdrop of slightly moderated credit growth, weak trade data (Exports and Imports in Q1 both contracted 3.4%YoY and 1.7%YoY respectively, which despite predictions of a rebounding demand in Europe and the US were weaker than expected), a weaker property activity and producer prices that were down for the 25th straight quarter.

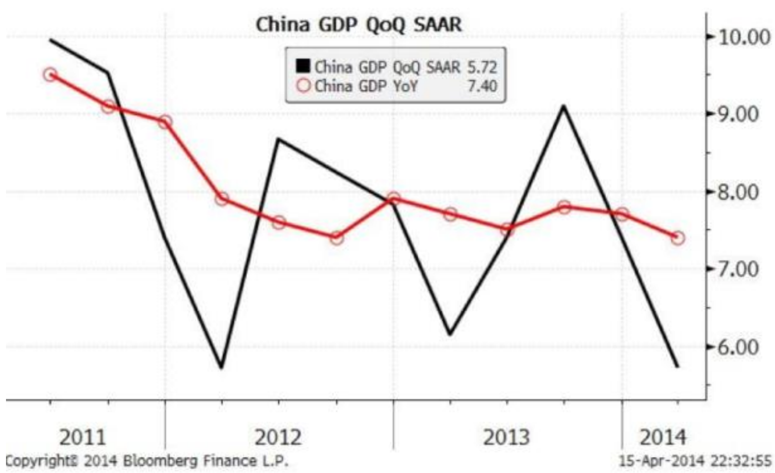

Figure 1 – China GDP QoQ SAAR (Source: UBS)

China's headline CPI[4] inflation in March was slightly higher (2.4%YoY) than in February (2%YoY), while the PPI[5] in March contracted by 2.3%YoY. This illustrates the currently weaker economic activity. Official unemployment at year end 2013 stood at 4.1%, and despite the obvious overall slowdown, the government announced that in 2013, a total of 13.1 million new urban jobs were created.[6] This will remain a major challenge given the low level of education of

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[1] Some economists prefer PPP rather than nominal GDP (based on the actual exchange rate) to measure economies. PPP is viewed as more stable and a better measure of how much a country's economy is 'worth' in terms of what its currency will buy.

[2] http://www.ft.com/intl/cms/s/0/c9b971a2-d111-11e3-9f90-00144feabdc0.html?ftcamp=published_links%2Frss%2Fworld_asia-pacific_china%2Ffeed%2F%2Fproduct&siteedition=intl#axzz316F7LCua

[3] For more on the PPP controversy in the US-China context, read http://blog.mpettis.com/2014/05/do-we-understand-the-math-behind-the-ppp-calculations/

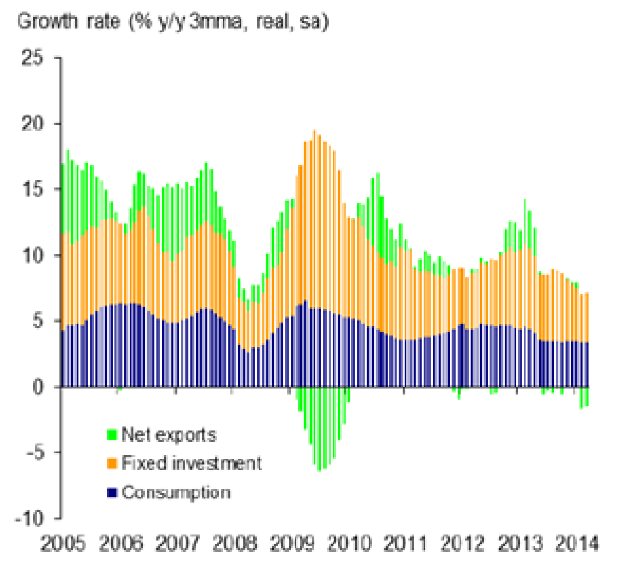
[4] Consumer Price Index

[5] Producer Price Index

[6] http://news.xinhuanet.com/english/china/2014-01/25/c_133073337.htm

the working age population in rural areas that the Chinese government is trying to attract to urban areas, where they should fit into an increasingly value-added, knowledge-driven economy.

Particularly fixed asset investments, a hitherto major contributor to the economic performance, has experienced its weakest performance since 2002, increasing by a still impressive 17.6% in Q1, well below the 20.9% expansion in Q1 2013. While the Chinese policies point in that direction, **Consumption has so far failed to offset weaker investment and export growth** (see Figure 2).



Source: CEIC, UBS estimates

Figure 2 – UBS expenditure index by source (Source: UBS)

The **slowdown of the property activity since the beginning of the year has accelerated in the past few months.** The real estate supply has been growing faster than the demand, and investment demand for housing is cooling down while inventories continue to build up. The sale of housing in the first 4 months of 2014 has decreased by 9.9% and new construction has even fallen by 24.5% in comparison to the same period last year[7]. Usually the property bubbles are analyzed from the price correction angle. However in the China context, experts estimate the construction volume correction is more important than the impact of the price correction, as the construction sector is such an important pillar of China's growth. Therefore a drop in the construction volume of 10% could result in a loss of 2,5% in GDP growth given the fact that not only property developers but also heavy industries like metals, construction materials and machineries would be strongly affected. The financial sector would then suffer most from the worsening of the balance sheets of constructors, corporates, loans collateralized by property, future projects and land. Given that transaction volumes have fallen and prices have been cut, repayment of debts for developers is getting increasingly difficult due to liquidity problems. An easing of the restrictions is therefore likely in 2014.

Whereas increased migration and old housing stock will sustain a demand for new housing, the pace of supply will have to come down markedly as currently there is far too much unused housing on the market. **This is likely to be the end of an era when a secular property and construction boom was the main engine driving domestic demand.**

However, the likelihood of a crash which would result in a financial crisis or a balance of payment crisis is relatively low, as **household balance sheets are strong and could weather**

[7] Wall Street Journal, German Edition, 30 May 2014: "Die Immobilienkrise in China greift weiter um sich"

a downturn. Furthermore, whereas some local governments are starting to see liquidity problems, the central government has large firepower to intervene.

As a consequence of above elaborations, bearing in mind the need for structural reforms, and **as the weaker property activity has continued into the second quarter 2014, GDP growth is likely to remain weak throughout 2014, and will further slide in 2015 to 7% or even below**. It represents **the major risk in the upcoming months**, also owing to its close connection to the less regulated shadow banking products. Many trust loans are secured with property, and a cooling of the property market could initiate a vicious downward spiral. So far, shadow banking activity and credit growth has remained stable as the looming risk is understood. IHS, a consultancy, estimates however that GDP might slow down from a forecast 7.5% to 6.6% this year, and to 4.8% next year in case of a sharp downturn in some sectors.

This will therefore remain the major challenge for the Chinese authorities, namely to balance the envisaged liberalization in the market with keeping in check the potentially harmful excesses in the shadow banking sector.

The government took action when it **announced on April 2nd a mini-stimulus package that should stimulate small businesses and innovative industries as well as consumption**. While tax breaks for small and micro firms shall unleash innovation, new railways and subways as well as low-income housing shall ensure employment and boost consumption. Economists seem to agree that it is not a stimulus of the sort of what happened in 2008 and 2013 where major infrastructure investments led to a rebound of the economy, resulting however in massive overcapacities and heavy debt.[8] The government itself emphasizes that the reform plans shall be pursued and the mini-stimulus is to be seen as in line with this reform push.[9]

The Central Economic Work Conference and the National People's Congress decided upon a **"stable" monetary policy stance for the coming year**, maintaining the 13% M2 growth target from the previous year and calling for "stable" monetary and financial conditions alongside an "appropriate" pace to TSF[10] growth. **While the biggest risk for 2014 is expected to come from the property sector, economists expect GDP to grow by 7.4% in 2014, the weakest annual expansion since 1990**[11].

This would be in line with the **government's goals for 2014** that were revealed in the work report of Premier LI Keqiang to the National People's Congress in March this year. These goals are namely:

> Increase GDP by about 7.5%, keep the rise in the CPI at around 3.5%, create ten million more urban jobs, ensure that the registered urban unemployment rate does not rise above 4.6%, achieve basic balance in international payments, and increase personal incomes in line with economic development. We need to make overall planning for and balance major targets, namely, economic growth, employment, prices and international payments.

While the wording "about" with regards to GDP growth has created certain confusion, it represents according to the Chinese government a range – rather than a fixed target – that will be reached given the employment is sufficient and no major fluctuations in the economy occur. As double digit growth rates belong to the past, the major concern of the new administration is ensuring employment.

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[8] Reuters reported that within a month, China has seen the first domestic corporate bond default, the first domestic junk bond default, and two bank runs.

[9] *"We will not resort to short-term massive stimulus policies just because of temporary economic fluctuations and we will pay more attention to sound development in the medium to long run and strive for sustained and sound economic development."* (LI Keqiang's speech at opening ceremony of Boao Forum 2014, http://english.people.com.cn/business/8594954.html)

[10] Total Social Financing

[11] In that year, China was under international sanctions due to the incidents that happened on Tiananmen Square in 1989

1.1 Rebalancing of the economy

On its way to rebalancing the economy, it is clear that should the government be serious about getting the economy away from export-led and investment-driven growth, this will only be possible with slower GDP growth rates in the short run. Rather positive about recent data, the Peterson Institute of International Economics sees this rebalancing on a good way and states: *"Despite the somewhat gloomy overall economic data, the prospects for economic rebalancing in China actually improved in the first quarter of 2014. Disposable income grew strongly, narrowing the gap with GDP growth. Real interest rates remained in positive territory. The growth of loans to small enterprises accelerated while loans to large enterprises slowed. The tertiary sector continued to grow faster than the industrial sector. These factors all combined to outweigh the continued drag on rebalancing due to excessive investment in residential real estate.* ***China's headline growth numbers have seen better days, but this is the most positive outlook we've seen for rebalancing since 2012."***[12]

Premier LI in his work report acknowledged the challenges ahead, among others the risks hidden in public finance and banking, overcapacities, the more challenging macro-controls, rural incomes, environmental problems, employment issues, and health considerations as well as the social security system.[13] **While the narrative of China being a developing country in the primary stage of socialism is still being embraced, it is understood that development in the economic realm "remains the key to solving all our country's problems"**. The long-term goal remains the building of a moderately well-off society *(xiaokang shehui*).

From a political point of view, the **conditions for economic reforms have improved substantially since the leadership change**. President XI very quickly managed to consolidate his power with his anti-corruption and mass-line campaigns and keep his adversaries and vested interests opposing reform in check. What is more, XI's tenure will last until 2022, and during the next leadership change in 2017, all the members of the Politburo Standing Committee other than him and Premier LI will be replaced due to age, providing XI with the opportunity to remove the remaining opposition within the central party ranks and effectively push through reforms.

It is therefore little surprising that **in the 2013 Central Economic Work Conference (CEWC)[14] the main focus was put on development and reform activities**. This time, the six major tasks identified for 2014 were: Guarantee national food security, Vigorously adjust industrial structure and reduce industrial overcapacity, Prevent and control local government debt risk, Promote coordinated regional development, Improve and guarantee people's livelihoods, and Promote further opening up. **Food security as the number one issue is top on the agenda this year**, mirroring the worrisome reports earlier this year on the quality of available farmland across the country. China is the world's largest producer and consumer of agricultural products. The country has to feed nearly a fifth of the world's population with only 9 percent of the world's land and 6 percent of the world's water resources. **A recently published report by the Ministry of Environmental Protection[15] revealed that nearly one fifth of the country's arable land (133m hectares) is polluted.** China's Ministry of Land and Resources already declared in December that roughly 2.5% of arable land is unfit for farming. These data show that China is paying its price for its breakneck economic development, and that the "red line" for the amount of farmland necessary to feed the population is becoming a real issue. Consequently, the goal of 95% self-sufficiency for grain will be hard to achieve and China will have to rely more heavily on food imports. Already in 2013, China became the world's No. 1 rice importer, buying 3.4 million tons of the grain from overseas.

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[12] http://blogs.piie.com/china/?p=3875

[13] Report on the Work of the Government, March 5 2014

[14] The CEWC is an annual high-level meeting that sets the direction for economic policy in the following year.

[15] http://www.mep.gov.cn/gkml/hbb/qt/201404/t20140417_270670.htm (Chinese)

If the Chinese government is to be believed, Urbanization shall be the main driver of the country's economic growth that cannot rely any longer on exports and investments alone. The attention for the issue is rising. Last year's Central Urbanization Work Conference (CUWC) was described by Xinhua as "the most high-level meeting the Chinese leadership has ever convened on urbanization". Later, in March, the State Council and the CPC released the blueprint "National New-type Urbanization Plan (2014-2020)", that finds that: **"Domestic demand is the fundamental impetus for China's development, and the greatest potential for expanding domestic demand lies in urbanization"**. Hukou reform has been identified as the number one priority. With over 20 million Chinese expected to migrate to urban centres every year (with an expected urbanization ratio of 60% by 2020, compared to 53% today and 18% in 1978), this economic transformation is expected to unleash enormous consumption and investment demand while creating urban job opportunities. The "new type" indicates that new ways have to be found as the old model in which urban construction relied on land sales and fiscal revenue is unsustainable. Some economists however point out that no other country has been using urbanization as a tool for growth. Growth in general leads to urbanization, not the other way round. It remains yet to be seen how and whether China can defy this common economic wisdom.

1.2 Sector-specific developments

The **liberalization of the financial market is top on the government agenda, however a cautious step by step approach is to be expected**. Many concrete measures (for instance at the China (Shanghai) Free Trade Zone) still remain too unclear for it to provide for better market access as of now. In the aftermath of the Third Plenum, the Governor of the People's Bank of China (PBoC) announced on the 19th of November that it will "basically" end normal intervention in the currency market and broaden the RMB's daily trading limit. Also the investment caps for both domestic and foreign investors will be phased out and the ceiling for deposit rates gradually removed. Furthermore, the current capital control mechanisms, such as QFII and QDII, will be expanded and scrapped when conditions are mature, so that all legal institutions could invest freely in domestic and foreign jurisdiction. Regarding interest rate liberalization, PBoC reiterated the commitment to build an interest rate regime driven by market supply and demand. PBoC also announced its plan to promote interbank issuance, and trading of certificates of deposits to start soon. Financial regulations will be improved by additional capital requirement for important banks to improve flexibility to react on counter-cyclical capital needs and by closing regulatory vacuums.

After news of offshore accounts held by prominent Chinese leaders and affiliates have been released in early 2014 (aka 'Chinaleaks') by the International Consortium of Investigative Journalists (ICIJ), it is **expected that China will uphold its active role in the OECD** both with regards to the Declaration on BEPS (Base Erosion on Profit Shifting), as well as in its role as vice-chair of the OECD steering group on Transparency and Exchange of Information for Tax Purposes. This is to be understood as an attempt to claim tax revenue that is increasingly being shifted abroad. As this is a prevalent phenomenon in the developing world, China might see itself at the forefront of such programs.

Perhaps the most interesting economic development, however, happened in late February and had nothing to do with China's reform policy. After a steady appreciation over the past years against the USD (more than +25% since 2005), the RMB depreciated significantly from late-February through March. **Arguably for the first time, the market was taken by surprise by the central bank which let the Yuan slide starting February 18 from RMB 6.06 to RMB 6.145 against the dollar within a fortnight.** Hitherto the central bank would inform banks beforehand in a "guided" approach. While for some this has been interpreted as a defense strategy by the PBoC to prevent hot money from flowing in, others were worried that this could be a change in policy of Beijing aiming at a devaluation which could initiate a round of competitive devaluation in the whole of Asia. The PBoC explained it as a natural correction by the market referring to the average devaluation of the rest of emerging market currencies by 8,2% during 2013, while the RMB still appreciated by 2,5% in the same period. In mid-March the

PBoC doubled the trading range around which the daily midpoint rate is allowed to rise and fall to a level of 2% in both directions. Since the new range has been introduced the volatility has grown and led to a devaluation of 2,3% since the beginning of the year.

More information on the Shanghai Free Trade Zone (SHFTZ) has been trickling out in recent months. This pilot project was initially launched by Premier LI Keqiang in September 2013 with the goal to provide opening and liberalisation in the services sector. It was welcomed with euphoria, stressing the novelty of the negative list approach that the government announced for the first time with regards to investments. While most of the announced policies still remain vague, it seems that the Shanghai authorities are not as autonomous as might have been expected and that the central government in Beijing remains in the driver's seat. Hence, the Shanghai People's Congress anticipates that the regulations will fall short of the public's expectations. At the same time, foreign-funded firms still shy away from commitments and are still the exception in the zone, making only 6% of all businesses registered. In the meantime, Beijing gave preliminary approval for 12 new FTZs around the country, adding up to the already great pressure on Shanghai to deliver some concrete results. It therefore remains to be seen what becomes of the promising announcements.

2 International and Regional economic agreements

2.1 China's Policies and Priorities

In light of the slow progress with the Doha round, China is also increasingly looking at bilateral and regional economic cooperation in its foreign economic policy.

In one such newly launched project, **China is working towards the establishment of an Asia Infrastructure Investment Bank (AIIB)**. With a focus on infrastructure construction in Asia to promote regional connectivity and economic cooperation, the AIIB should complement existing institutions (World Bank, Asian Development Bank) that focus more on poverty reduction. While funds are scarce in the existing institutions, a fund of USD 50 billion will be set up to fund infrastructure projects in Asia. A Swiss participation in the AIIB has repeatedly been solicited.

2.1.1 China and the WTO

In the WTO accession process China has been categorized as a developing country, benefiting from special treatments and exclusions within the WTO. It is a classic example of an **emerging economy still benefiting from these advantages**, despite the tremendous economic development. Most industrialized countries claim that emerging economies should make more concessions than other developing countries. Although China is perceived in many fields as a **constructive partner**, particularly in issues typically affecting emerging markets, it has **not adopted a leading role yet.**

China's recent experience with the **WTO's Dispute Settlement Body (DSB)** suggests that the country is gradually internalizing the non-discrimination principle embodied by the multilateral trading regime, committing to comply with all DSB rulings and redress its WTO-inconsistent policies in a number of cases. In March this year, the WTO confirmed that China had lost a case on rare-earth metals as China's export duties on rare-earth metals are inconsistent with WTO obligations.[16]

The diminishing reliance on Western markets for exported Chinese goods implies a development strategy geared towards increasing domestic demand and market diversification. While China keeps engaging in multilateral trade discussions and protecting its interests within the WTO, it is also actively exploring trade opportunities through **regional trade agreements** with strategic partners.

[16] http://online.wsj.com/news/articles/SB10001424052702304418404579463073051039380

2.1.2 China towards RCEP vs. TPP

China aims at playing a more active role in the ASEAN-led RCEP (*Regional Comprehensive Economic Partnership*)[17] negotiation process formally launched during the 2012 ASEAN Summit in order to counterbalance the US-lead TPP (*Trans-Pacific Partnership*). The RCEP negotiations will be concluded by 2015, accounting for 27% of global trade with a combined GDP of $21 trillion, covering a 3 billion people market.[18] RCEP's 4th round of negotiations was held in Nanning from March 31st to April 4th and the 5th will be held in Singapore from June 23-27th June 2014. So far, Working Groups in Trade in Goods, Services, Investment, Competition, Intellectual Property and Economic and Technical Cooperation were held and further Working Groups on Sanitary and Phytosanitary Measures, as well as Standards, Technical Regulations and Conformity Assessment Procedures will be established.[19]

While China is aware that it may not be leading the RCEP process, it is eager to accelerate it while the US aims a conclusion of the TPP by the end of 2014, despite certain domestic reluctance within the Senate. The TPP represents 30% and 40% of global trade and GDP respectively. China does not meet the TPP requirements yet, such as the rules in IP, generic pharmaceuticals, rules of origin or liberalization of services. Japan's recent accession made China respond by reinforcing the roles of ASEAN and APEC as the lead institutions in the region to weaken the US and Japanese influence.[20] TPP's fast progress obliges RCEP's upgrade[21] and opening up to more sectors, thus challenging China to reform its services and foreign investment policies.[22] Korea has recently completed a comprehensive preferential trade arrangement with the US and aims at joining the TPP, along with India, Taiwan, Thailand and the Philippines.[23]

The original TPP fundament was laid on inclusive, rule-based multilateralism to align and not divide the Asia Pacific in a cohesive pact. For most TPP Parties, Chinese accession would be preferable after the framework has been set. The TPP represents a triple threat for China, namely trade diversion, exclusion from negotiations on the future shape of trade in the Asia Pacific and a diminishing geostrategic role.[24] Both RCEP and TPP are not only trade, but also geopolitical rivals, however the TPP aims rather at creating the next generation of trade rules while RCEP is trying to build a unified market by eliminating the FTA proliferation's 'spaghetti bowl'-effect. RCEP will be weaker than TPP, with lower standards and excluding labor and environmental protection. China is the major trading partner for most RCEP and TPP members; the question is not whether China will join the TPP *per se*, but rather whether it will be allowed to actively participate in the shaping process.

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[17] ASEAN+6: Australia, China, India, Japan, New Zealand and South Korea.

[18] http://mfat.govt.nz/Trade-and-Economic-Relations/2-Trade-Relationships-and-Agreements/RCEP/index.php

[19] http://english.mofcom.gov.cn/article/newsrelease/significantnews/

[20] http://www.chinausfocus.com/finance-economy/should-china-join-the-trans-pacific-partnership-talks/

[21] Seven RCEP countries are TPP parties and one day TPP and RCEP may be integrated, if linked to the EU it would lead to 80% of the global trade.

[22] http://www.economist.com/blogs/banyan/2014/02/trans-pacific-partnership-0

[23] http://www.eastasiaforum.org/2014/03/20/china-debates-the-tpp/

[24] http://blogs.piie.com/china/?p=3631

Trans-Pacific Partnership	Regional Comprehensive Economic Partnership	
APEC	East Asia Summit	
Australia	Brunei	
Brunei	Cambodia	
Canada	Indonesia	
Chile	Laos	ASEAN
Japan	Malaysia	
Malaysia	Myanmar	
Mexico	Philippines	
New Zealand	Singapore	
Peru	Thailand	
Singapore	Vietnam	
Vietnam	China	
United States	Japan	ASEAN + 3
	South Korea	
	Australia	
	India	ASEAN + 6
	New Zealand	

Figure 3 – TPP vs RCEP[25]

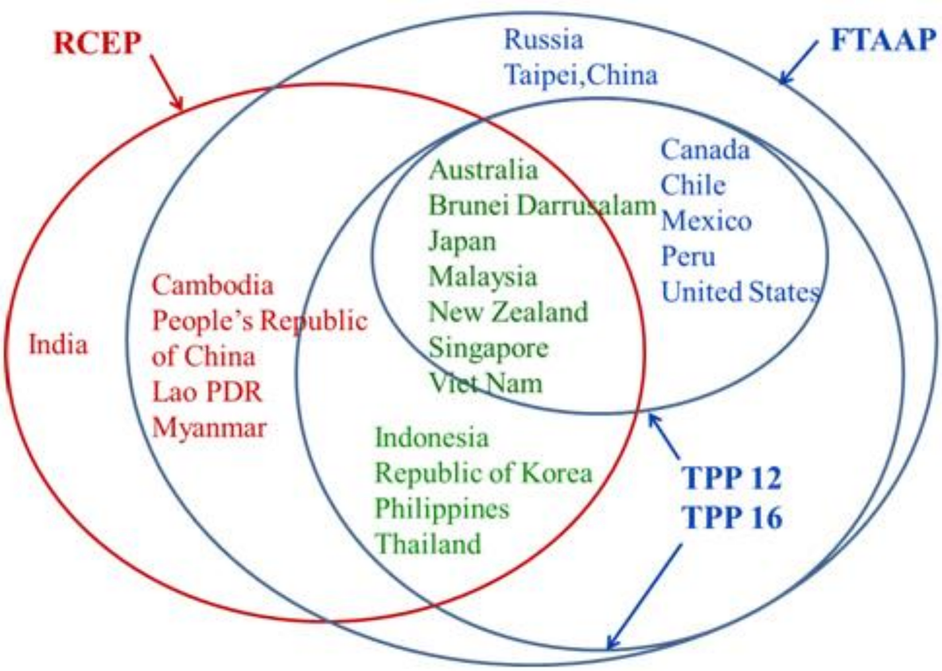

Figure 4 – RCEP, TPP and FTAAP Tracks[26]

2.1.3 Bilateral Free Trade Agreements (FTAs) Concluded

The CEPA (*Closer Economic Partnership Agreement*) between mainland China, Hong Kong and Macao was the first regional trade agreement concluded in 2004. In 2010, CAFTA (*China-ASEAN Free Trade Agreement*) came into effect, which was followed by APT (*ASEAN Plus Three*: China, Japan and South Korea), representing RCEP's base. Since then, China has concluded numerous bilateral FTAs with **Costa Rica (2010), Pakistan (2009), Senegal (2008), Peru (2008), Singapore (2008), Chile (2008) and New Zealand (2008)**, the latter being the first industrialized country to sign an FTA with China**. Iceland** signed an FTA in April while **Switzerland** signed on July 6th 2013, both being expected to enter into force on 1st July 2014.

[25] http://www.aspistrategist.org.au/trade-partnership-competition-tpp-vs-rcep/

[26] http://www.asiapathways-adbi.org/2013/12/a-vision-of-global-free-trade-the-new-regionalism-and-the-building-blocs-debate/

2.1.4 Free Trade Agreements under Negotiation

China, **Japan and Korea** launched their **trilateral FTA** negotiations in November 2012, with the 4th round held in March in Seoul. So far, working group meetings were held on trade in goods, services, IPR and e-commerce. Whether or not to include environmental standards, government procurement and food sectors is high on the agenda.[27] The combined GDP of the three countries represents 70% of Asian and 20% of the global GDP and the combined trade volume accounts for 17.5% of global trade.[28]

China and **South Korea** launched negotiations for a bilateral FTA in March 2012, which is aimed to be concluded ahead of the trilateral FTA. The 10th round was held in mid-March. Both sides completed the first phase during the seventh round in August 2013 and a breakthrough was reached as the tariff modalities of NSI (Non-sensitive Items), SI (Sensitive Items) and HSI (Highly-sensitive items) were defined. Seoul and Beijing tentatively agreed to abolish tariffs on 90% of all products and opened the door for raising the threshold during the second-phase negotiations.[29]

Australian Prime Minister Tony Abbott, President XI Jinping and Vice Premier WANG Yang all indicated during their meeting on April 11th the aim to conclude the FTA before the end of 2014 after 19 challenging rounds of negotiations. China is Australia's largest trade partner and biggest export market, while Australia is China's largest overseas investment destination.

Norway and China launched FTA negotiations in 2008, which were halted after 8 rounds because of the Nobel incident in 2010. According to Vice-Minister of Commerce YU Jianhua's statement, which reflects the Chinese status since then, Norway has raised demands deemed difficult for Chinese industries for which neither side has proposed solutions. The negotiations are still halted and Norway would welcome any Chinese initiative to resume them. Norway supported the granting of Arctic Council observer status to China in order to normalize their bilateral relations. The **Gulf Cooperation Council (GCC)** and China launched FTA negotiations in 2004 and stalled in 2009 after five rounds, as China wishes to exclude services. President XI Jinping called for resuming the negotiations during the visit of the King of Bahrain Sheikh Hamad bin Isa Al-Khalifa at the Great Hall of the People last September. China is also an **APTA (Asia-Pacific Trade Agreement)** signatory, formerly known as Bangkok Agreement, signed in 1975 as an initiative of the UNESCAP (United Nations Economic and Social Commission for Asia and the Pacific). The fourth session on the APTA Ministerial Council on tariff concessions is scheduled for 2014.[30] China and **Sri Lanka** have completed a joint feasibility study in March this year and aim at concluding a FTA by the end of the year.[31] In June 2004, China and **SACU (Southern Africa Customs Union)** announced the launch of free trade negotiations. So far, no negotiations have taken place.

2.1.5 Free Trade Agreements under Consideration

As the negotiations on a TTIP (*Transatlantic Trade and Investment Partnership*) are progressing, China has shown strong interest in negotiating a **China-EU** FTA despite the anti-dumping disputes earlier this year. However, this option will only be taken into consideration once the **Bilateral Investment Treaty** (BIT) is concluded and remedies to obstacles such as subsidies, export credits and cheap loans are found. The BIT negotiations were officially launched in November 2013 and the 1st round of negotiations took place at the end of January 2014 in Beijing. China has already separate BITs with every EU Member State except for Ireland; however the new China-EU BIT would supersede the previous individual agreements.[32]

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[27] http://www.thebricspost.com/china-japan-s-korea-fta-talks-constructive/
[28] http://news.xinhuanet.com/english/china/2014-03/04/c_133159106.htm
[29] http://www.globalpost.com/dispatch/news/yonhap-news-agency/140316/s-korea-china-begin-new-round-fta-negotiations
[30] http://fta.mofcom.gov.cn/topic/enpacific.shtml
[31] http://www.reuters.com/article/2014/02/13/us-china-srilanka-idUSBREA1C0IU20140213
[32] http://www.economonitor.com/blog/2014/01/china-eu-investment-pact-on-the-right-track/

A **US**-China bilateral FTA lies further ahead on the horizon of both most powerful economies, although the US aims first at concluding the TPP and the **China-US BIT**.[33] Both economies agreed last July to restart stalled negotiations on the BIT launched in 2008, the 12th round was held in March in Washington and a completion for the end of 2014 is endeavored.[34] The regime created by a China-US BIT could significantly accelerate the reform of Chinese FDI regime, which has slowed down in recent years, and in fact give impetus to China's domestic reforms.

A feasibility study for a China-**India** Regional Trade Agreement was completed in 2007 and earlier this year, Premier LI Keqiang expressed the desire to start FTA negotiations with India to mitigate the trade imbalance. The Indian government and industries however remain concerned by the influx of Chinese goods and are reluctant to start negotiations in the near future. China, as Mongolia's main importer of mineral resources, initiated feasibility studies for a FTA with **Mongolia** in 2010. An agreement in economic and technological cooperation was signed during WU Bangguo's visit to Mongolia early 2013, which was the first high-level visit to Mongolia in 16 years.[35] In October 2013, Prime Minister Norov Altankhuyag held bilateral talks with Premier LI Keqiang, the latter underlining that China would be ready to discuss the establishment of a FTA with Mongolia.[36]

Launching a FTA with **Canada**, **Brazil** or **SCO** (*Shanghai Cooperation Organization*) are also in China's FTA expansion strategy, however, this general trend may lead to an increasingly complicated effect where one agreement may overlap another, synergies among them will thus have to occur sooner rather than later.

2.1.6 Relations between China and Taiwan

Although relations between China and Taiwan reached a peak thanks to the historical dialogue initiated on February 11th in Nanjing, Taiwan has been facing the most serious political crisis since the Sunflower Movement started on March 18th, one day after the ruling Party Kuomintang (KMT) unilaterally passed the ***Cross-Strait Services Trade Agreement*** **(CSSTA)** signed in June 2013 with Mainland China. Under CCSTA, a successor of the landmark ECFA (*Economic Cooperation Framework*) concluded in 2010, China would open 80 service sectors to Taiwan, while the latter is to open 64 to China.

In the heart of criticism lie the lack of transparency and the growing skepticism of Mainland China exerting increasing economic control over Taiwan, which might lead to a political annexation in the long-term. Furthermore, some fear that the Taiwanese industry and services are disappearing as investments and jobs shift to the mainland. The crisis has widened the gap between existing factions within the KMT. With upcoming elections in 2016, the CSSTA controversy will likely force future candidates to distance themselves from President MA Ying-jeou's cross-strait liberalization policies.

The numerous FTAs that China is signing with other countries may have a negative impact on Taiwan, as the latter has a strong trade dependence on the former. In order to not be singled out from the international trade liberalization trend, President MA Ying-Jeou has committed Taiwan to join RCEP and TPP by latest 2020.[37] The 8th round of talks with the **US** under **TIFA** (*Trade and Investment Framework Agreement*) was successfully held in the first week of April.[38] Taiwan seeks to tackle this dependency in concluding other trade deals, such as **ANZTEC** (*Agreement between **New Zealand** and the Separate Customs Territory of Taiwan, Penghu, Kinmen and Matsu on Economic Cooperation*) which entered into force on December 1st, 2013. ANZTEC

[33] http://www.vcc.columbia.edu/content/china-united-states-bit-negotiations-chinese-perspective;http://www.ft.com/intl/cms/s/0/b8b391ec-a634-11e3-8a2a-00144feab7de.html#axzz2z7cnKe5r
[34] http://www.reuters.com/article/2014/02/10/idUSL2N0LF12I20140210
[35] http://usa.chinadaily.com.cn/world/2013-01/31/content_16188990.htm
[36] http://www.fmprc.gov.cn/mfa_eng/
[37] Taiwan has already signed FTAs with Panama, Guatemala, Nicaragua, Honduras and El Salvador, representing however only less than 1% of foreign trade. Feasibility studies have been completed with India, Indonesia and the Philippines and negotiations are under way with Costa Rica and the Dominican Republic.
[38] http://www.chinapost.com.tw/taiwan/foreign-affairs/2014/04/08/404784/Taiwan-US.htm

includes substantive chapters on trade, labour, environment and indigenous people. Similarly, **ASTEP** (*Agreement between* ***Singapore*** *and the the Separate Customs Territory of Taiwan, Penghu, Kinmen and Matsu on Economic Partnership)* was signed on November 7th 2013. Taiwan hopes that the two agreements may allow an entry point into the TPP as both New Zealand and Singapore are its founding members.

Agreements on e-commerce and patent protection were signed with **Japan** on November 5th 2013 and agreements on financial supervision, taxation, customs and trade in services are sought to be signed as a next step towards a free trade agreement. End of October 2013, the European Parliament called on the European Council and the European Commission to facilitate negotiations for a Taiwan-**EU** Economic Cooperation Agreement.

2.2 Outlook for Switzerland

On **July 6th 2013, the China-Switzerland FTA was signed** by Federal Councillor Johann N. Schneider-Ammann and Chinese Minister of Commerce GAO Hucheng. The FTA contains chapters on trade in goods, trade in services, rules of origin, customs procedures and trade facilitation, technical barriers to trade (TBT) and sanitary and phytosanitary measures (SPS), trade remedies, intellectual property rights, competition, investment promotion, government procurement, trade and sustainable development, dispute settlement, legal and institutional matters, economic and technical cooperation. Side Agreements on Labour and Employment, on Cooperation in the Area of TBT and SPS, Certification and Accreditation, Telecommunication and on Mutual Recognition of Test Results of Measuring Instruments have also been signed on this occasion.[39] The FTA has been ratified by both countries and will enter into force on July 1st 2014. It provides a legal framework including consultations and dispute settlement mechanisms. A **Joint Committee will meet at least every 2 years** and various **sub-committees** are set-up to monitor the implementation of the agreement.

The provisions of the FTA will improve mutual market access for goods and services, enhance legal security for the protection of intellectual property and bilateral economic exchange in general, contribute to sustainable development and deepen bilateral cooperation. This is a window of opportunity for Switzerland, before China’s focus could shift to other economies once new FTAs are signed.

3 Foreign Trade

3.1 Development and General Outlook

3.1.1 Trade in goods[40]

In 2013, Chinese exports reached USD 2.2 trillion (+7.9% YoY) and imports stood at USD 1.95 trillion (+7.3% YoY), resulting in a total trade volume of USD 4.16 trillion (+7.6% YoY) and leaving a trade surplus of USD 259.73 billion (+12.4% YoY). China’s share in world merchandise exports account for 11.4%, putting the country in the lead before the US (8.6%) and Germany (7.8%).[41] Combined together with goods imports, **China has in 2013 overtaken the US as largest goods trader (total US trade volume USD 3.88 trillion[42]) and claimed back the position that the Middle Kingdom arguably had in the late Qing Dynasty** (1644-1912). The rise to dominance has been an extremely fast one, with the value of Chinese trade roughly doubling every four years over the past three decades. According to the IMF, imports and exports will in the coming years still grow faster than world trade overall, with China’s share of world trade expected to reach 13.7% by 2018 (up from 3.7% in 2000, and 10.6% in 2012).

[39] For all texts of the agreement, please refer to: http://www.seco.admin.ch/themen/00513/00515/01330/05115/index.html?lang=en

[40] Data mainly based on China’s Custom Statistics

[41] WTO International Trade Statistics 2013

[42] US Department of Commerce

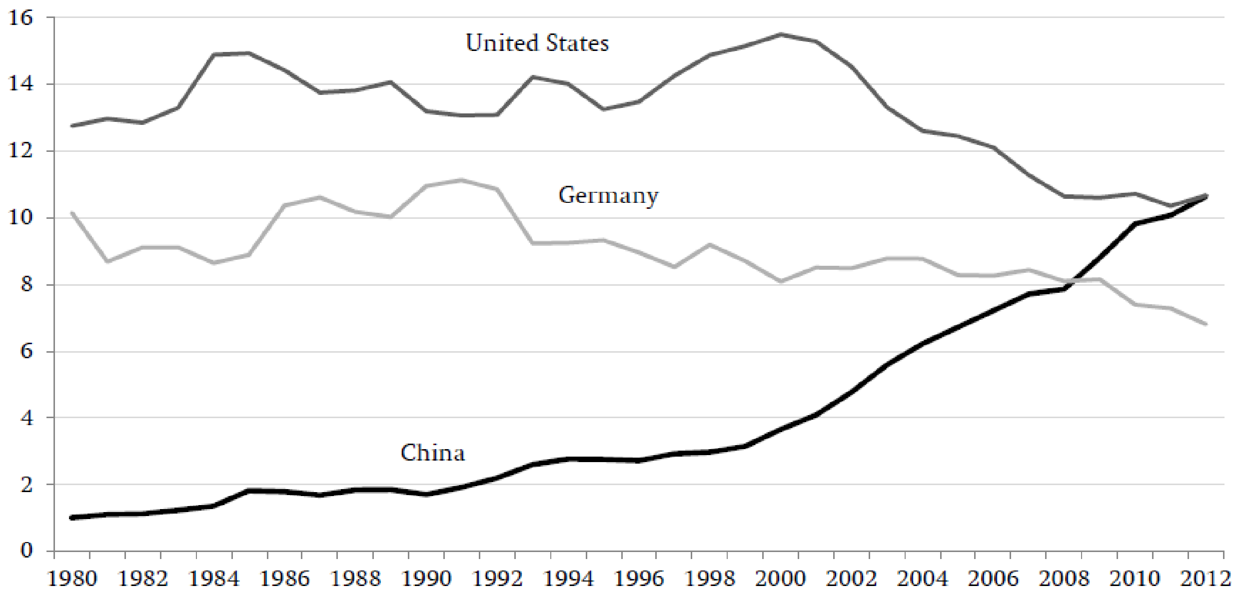

Figure 5 – China's rise to a leading trade power: share of world trade in percent

In terms of traded goods, a shift is emerging from exporting textiles, apparel and oil products to high-tech machinery and electronics. At the same time, imports of components brought to China for assembly are on the decline, indicating a **move away from the practice of importing cheap components for assembly and re-export**. Official figures show the processing trade made up 32.6% of total imports and exports in 2013, a drop from 34.8% in 2012.[43] **Foreign invested enterprises dominate trade in China**, making for 52.4% of exports and 49.6% of imports in 2011, 86% of high-tech exports (2010) and 21.6% of China's value added.[44] This is to be seen in particular against the backdrop of the accession to the WTO in 2001, after which China has become a major investment destination.

Hong Kong has overtaken the US as China's top trading partner for exports in 2013[45] (17.4% of overall export from China, +19.0% YoY), followed by the US (16.7%, +4.7% YoY) and Japan (6.8%, -0.9% YoY). **On the import side, South Korea takes the lead** (9.4%, +0% YoY), followed by Japan (8.3%, -9% YoY), China[46] (8.1%, +10% YoY), Taiwan (8.0%, +18% YoY) and the US (7.8%, +15% YoY).

While discrepancies (the US report imports of USD 438.1 billion from China, China reports USD 368.4 billion to the US) often exist between trading nations, the Chinese trade figures have in recent years also been suspect to distortions through fabricated transactions, especially in its trade with Hong Kong.[47]

3.1.2 Trade in services[48]

According to the White Paper on China's foreign trade **China's international competitiveness in services trade has been enhanced**, especially since its WTO entry. From 2001 to 2010 **China's total services trade value (excluding government services) witnessed a more-**

[43] http://www.ft.com/intl/cms/s/0/7c2dbd70-79a6-11e3-b381-00144feabdc0.html#axzz31eqWFKf7

[44] http://www.swp-berlin.org/fileadmin/contents/products/research_papers/2014_RP01_hlp.pdf

[45] A substantial share of Chinese exports is re-exported through the customs territory of Hong Kong, resulting in the statistics however in an export to Hong Kong. This is a major reason for trade statistics discrepancies between China and importing countries.

[46] Commodities originally made in China, which are exported to FTZs, HK, other countries, Export processing zones etc., and then re-imported by China.

[47] http://www.forbes.com/sites/gordonchang/2014/01/12/is-china-really-the-worlds-no-1-trader/

[48] Data mainly based on WTO International Trade Statistics 2013

than-five-fold growth from 71.9 billion USD to 362.4 billion USD. [49] In 2012, commercial exports stood at USD 190.4 billion, commercial imports at USD 280.2 billion, resulting in a total trade in services of USD 470.6 billion and a trade deficit of USD 89.7 billion. Trade in services made roughly 10.8% of overall trade in 2012 (compared to 21.2% in the US).

China's share in world total exports was 4.4% with 190.4 billion USD (+8%) in 2012, and its share in world total imports was 6.7%, worth 280.2 billion USD (+18%). As such, China is ranked fourth in the world in services traded. In comparison, the US commercial exports make roughly 14.38% of the world total, while the US commercial imports make 10.02% of the world total.

While the Bali summit early December 2013 saw an agreement in trade facilitation, the summit was overshadowed by the **failure to sign an Information Technology Agreement (ITA)**, an intended update to the 1997 version. Beijing was mainly blamed for this failure. In this environment, the **TiSA (Trade in Services Agreement) talks are slowly progressing**. TiSA not only seeks to open services sectors, but also to develop new rules, like those applied to government procurement of services, licensing procedures or access to communication networks. TiSA is a talk of largely rich-world countries around the US and the EU that covers about 70 percent of global services with a value of USD 4 trillion.

A report by the US-China Economic and Security Review Commission (USCC) reveals the caveats that still exist for an entry of China into the TiSA. **Despite the WTO accession, China has so far done little to open its service sector.** Lucrative sectors are still dominated by SOEs[50]. While the US fears that an accession of China might water down the agreement, others point at the gains from liberalizing services. The Peterson Institute in 2012 concluded that the overall trade gain would rise by 30 percent if Brazil, India, and China should join. On top of that, if done on a MFN basis through TiSA, it is believed that the agreement could pave the way for other trade agreements with China.

Reasons for slow opening of this sector are mainly to be found in the vested interests, i.e. in the Chinese companies that stand to be outcompeted should the sector be liberalized. China runs a deficit in services, unlike in its trade in goods. Most services sectors are not internationally competitive. On the one hand, certain "pillar industries" such as telecommunications, banking & insurance, oil & gas, aerospace, and media are dominated by SOEs and wield powerful influence over the leadership. It is therefore not surprising that the market share of foreign banks actually declined from 5% in 2011 to 2% in 2013. Another problem is the local fragmentation of downstream services (such as distribution and after-sales, who siphon off profits from manufacturers) that pay dividends or taxes into local coffers, and therefore tend to be difficult to be vertically integrated into foreign companies' value chain. On top of that, ministries such as the NDRC, SASAC or the Ministry of Finance have their interests, and wield more power than the Ministry of Commerce that eventually needs to negotiate TiSA.

Domestically, China's services are underdeveloped as well. While the tertiary sector in 2013 for the first time overtrumped the secondary sector with 46.1% (compared to 43.9% in the secondary sector), a number of industries (healthcare, education, and advertising) have seen a decline in share of GDP since 2005. About one-third of workers in China are employed in services, compared to three-quarters in the US. According to the 12th FYP, however, the tertiary sector is expected to contribute 47.2% of GDP by 2015, a though target if manufacturing activity picks up again. In the first months of 2014, the HSBC China Services PMI also indicated a slow expansion of the services sector that is not fast enough to offset the manufacturing slowdown.

The Chinese leadership announced in its communication after the third plenum the **intention to further open the services sector for international investors**. Based on the model of the China (Shanghai) Free Trade Zone (SHFTZ) that operates with a "negative list" approach,

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[49] Information Office of the State Council: White paper "China's Foreign Trade"; December 7th, 2011.

[50] According to an USCC report, SOEs accounted for over half of China's services in 2012.

investments in the field of finance, education, culture and health shall be further opened. Since then, however, communication on the SHFTZ has been fairly quiet and the current list "very much matches the categories for restricted and prohibited projects in the government's fifth Catalogue of Industries for Guiding Foreign Investment", says Gordon Orr, the Asia chairman of McKinsey.

While the market might still be underdeveloped in general terms, **one sector has seen a meteoric rise: e-commerce**. China is about to overtake the US as the global e-commerce leader. And with 600 million netizens (up from 2.1 million back in 2000) and an annual growth rate of 70 percent, the sector is forecasted to be larger than those of the US, Britain, Japan, Germany, and France combined by 2020.[51] Asked about the reason for this fast development, Jacky Ma, founder of e-commerce giant Alibaba, finds that **"in other countries, e-commerce is a way to shop, in China it is a lifestyle."**[52] While this might be true, the weak existing offline alternatives and retail chains certainly also facilitated this incredible rise. By end 2014, the sector is expected to reach 10% of all retail in China.[53]

3.2 Trade with Switzerland

China is **Switzerland's third most important foreign trading partner**. China is the largest buyer of Swiss industrial products in Asia and the third largest worldwide (after the EU and the United States). Together with Hong Kong (where transit happens), China is after Germany (18.7% of total goods exports) and the US (11.6%) the third largest destination for Swiss industrial products (7.4%). Imports from China and Hong Kong are ranked fourth (7.2% of total goods imports), after Germany (29.2%), Italy (10.3%) and France (8.2%).

3.2.1 Trade in goods

In 2013, **bilateral trade according to Swiss statistics stood at CHF 20.2 billion, which corresponds to an increase of 11.5% from 2012**. Switzerland exported goods to the value of CHF 8.8 billion to China (+11.9% YoY, 4.1% of all Swiss exports), with imports from China totalling CHF 11.4 billion (+11.1% YoY, 6.1% of total imports). This results in a **trade deficit for Switzerland of CHF 2.7 billion** in 2013 (2012 trade deficit of CHF 2.5 billion).[54] The Chinese Customs statistics record export figures of USD 3.5 billion to Switzerland (no change from 2012) and import of goods amounting to USD 56 billion (+145%), 82.7% of which are "commodities not classified according to kind". Several factors play into this huge statistical difference, one of them can be identified as the trade in precious metals, which will be included in the Swiss trade statistics in future years.

The main products exported by Switzerland to China in 2013 remain machines and instruments (26.16%, +3.6% YoY), watches (28.1%, -2.4% YoY) as well as chemicals and pharmaceuticals (28.5%, +39.6% YoY). Imports include machinery (43.0%, +18.5% YoY), textiles and clothing (17.9%, +6.2% YoY), as well as watch making components (10.6%, +13.6% YoY) and chemical products (7.51%, +3.5% YoY). This reveals an interesting feature of Sino-Swiss bilateral trade, which is that the two countries trade essentially the same products, but in different price classes. In the same period, Swiss exports to Hong Kong mainly were comprised of watches, jewellery, precious metals and gemstones (86%) and imported products of the same class (84%).

As for Hong Kong, even under the new calculation method of geographic origin, Switzerland still records a trade surplus which in 2013 stood at CHF 6.4 billion at a trade volume of CHF 10.0 billion. Therefore, regardless of the trade deficit vis-à-vis mainland China, it is worth noting that

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51 http://www.chinainternetwatch.com/2007/china-e-commerce-market-2020/

52 http://www.ptl-group.com/blogs/e-commerce-in-china-gain-entrance-into-a-completely-different-world

53 http://www.forbes.com/sites/quora/2014/05/08/how-did-alibaba-capture-80-of-chinese-e-commerce/

54 As of January 1st 2012 the Swiss Federal Customs Administration adapted its calculation concept with the aim of harmonizing its foreign trade statistics with international standards, newly taking into account the country of geographic origin, other than the country of production. The regulation substantially impacts on the Swiss trade balance with certain countries. See Economic Report June 2013.

Switzerland still has a positive trade balance vis-à-vis Greater China, with a surplus of CHF 3.7 billion for 2013.

After the internal procedures on both sides have been completed, the **bilateral Free Trade Agreement** signed between the two countries on 6 July 2013 will enter into force as of 1st July 2014. It is expected to boost bilateral trade in the coming years. Statistical data for the period from 1988 to 2008 show that Switzerland's trade with its FTA partners (measured in the first four years after the entry into force of the respective FTA) grew substantially faster than its worldwide international trade (total of exports plus imports). The comprehensive nature of the agreement will therefore create opportunities for the private sector to increasingly engage in bilateral economic activities. The subcommittees in the fields of Technical Barriers to Trade and Sanitary and Phytosanitary Measures (TBT/SPS) that will enter into force together with the FTA will further strengthen ties and facilitate economic cooperation.

3.2.2 Trade in services

Also trade in services is of importance. Many Swiss service providers operate in China (including banks, insurance companies, logistics companies, goods and quality inspection companies, corporate consultants) and conversely Chinese service providers show increasing interest in Switzerland as a business location.

The FTA is expected to provide a better framework for service providers on both sides to provide their services in either economy.

4 Direct investments

4.1 Development and general outlook

China attracted a record USD 117.59 billion in FDI in 2013, up 5.25 percent from a year earlier. In the same time period, newly approved Foreign Invested Enterprises amounted to 22,773, down 8.63% from the previous year.[55]

According to Chinese statistics[56] the top ten foreign investors in China according to foreign capital input, amounting to 93.15% of foreign investment in the country, were: Hong Kong *(78.302 billion USD)*, Singapore *(7.327 billion USD),* Japan *(7.064 billion USD),* Taiwan *(5.246 billion USD)*, USA *(3.353 billion USD)*, South Korea *(3.059 billion USD)*, Germany *(2.095 billion USD),* Netherlands *(1.281 million USD),* UK *(1.039 billion USD)*, and France *(762 million USD)*.

It is noteworthy that the **actual use of FDI in the service sector was US$61.45 billion, constituting over half of the total FDI in China for the first time.** This is in line with China's FDI policy of attracting foreign business from "quantity" to "quality" and to push its industry up the value chain. The social security service industry, electrical machinery repair industry and the entertainment industry were noticeable standouts.

In April 2011 a new draft of the "Foreign Investment Catalogue" was released and the final version was published in December 2011, entering into effect on January 30th 2012. Stipulating "encouraged," "restricted" and "prohibited" categories into which specific foreign invested projects fall, the Catalogue has long been a major guideline of China's market openness strategies. The following five investment areas shall be further encouraged: high-end manufacturing industry, high-tech industry, modern service industry, new energy industry and energy-efficient and environmentally friendly industries. Preferential policies for land use and tax breaks shall help attract foreign investment into these encouraged categories. The "negative list" approach piloted in the China (Shanghai) Free Trade Zone will according to the third plenum be

[55] MOFCOM

[56] http://english.mofcom.gov.cn/article/statistic/foreigninvestment/201402/20140200498911.shtml

the way the Chinese government will handle foreign investments in the future and mark a fundamental shift from the previous dirigiste approach.

Investors' confidence in China has taken a slight downturn in 2013. European companies reported a diminished financial performance (tighter margins), which was mainly attributed to a slower economic growth in Europe and China, to rising labor costs as well as increasing competition from privately-owned Chinese companies. Market access and regulatory barriers are still considerable, pointing at the need for significant economic reforms. As a consequence, future revenue growth optimism among European companies has shrunk to a four-year low of just 71%. Nonetheless, despite the relatively difficult times, China is still perceived as the best in the context of a challenging global situation, which is why **foreign companies will remain committed to this market**. Growth and profit outlooks are most expected in the pharma & healthcare, retail & hospitality as well as the consulting and food & beverage sectors. In line with this development, the share of European companies' revenue from China continues to rise and continues to contribute significantly to the proportion of global sales. While earlier motivations were cheap exports, European companies increasingly provide goods or services for the Chinese market – i.e. in China for China. An update on business confidence by the European Chamber of Commerce is expected to be released this summer and will feature in the next report.

Looking at the still fast development trajectory of China, it **becomes increasingly hard to justify not investing in China.** Over the course of the next decade, China's mainstream consumer is expected to explode from 6% in 2010 to 51% by 2020 as a percentage of urban households. The change is even more transformative if one considers the current government push for urbanization and the resulting influx of rural people to cities in the coming years.[57] **China therefore remains a top FDI destination**.

China has also become a source of outward direct investments (ODI). By the end of 2013, the total stock of Chinese offshore investment stood at about 644.2 billion USD, slightly more than half of Japan's and more than double Taiwan's stock[58]. From 2004 to 2011, China's outward investment grew substantially from 5.5 billion USD to 75 billion USD a year, and is expected to reach 150 billion USD by 2015[59]. In 2013, the US (13%), Australia (12%) and Canada (8%) are the main beneficiaries of China's growing ODI, which increased by 16.8 percent to USD 90.17 billion.[60] Looking at this growth rate, ODI is expected to outstrip FDI still in 2014. The US is in the leading position mainly due to the acquisition of the agribusiness Smithfield Foods Inc. that was acquired by Shuanghui for USD 7.1 billion, the biggest Chinese acquisition of an American firm so far. At the same time, investments in Australia have seen a decline, indicating a slowdown of acquisitions in the resource industry also in Africa and Latin America. With its growing foreign reserves, **China's ODI is likely to grow further in the coming years**.
According to MOFCOM, about 90 percent of the total outbound investment went into the following six industries: commercial services, mining, wholesale and retail, manufacturing, construction and transportation.

In a speech after the Third Plenum, Mr. Gao Hucheng, Minister of Commerce, encouraged Chinese companies to **go overseas and set up research and development facilities, learn from advanced production practices, establish marketing and sales networks, develop their own brands, and improve their international competitiveness.** This is to be understood against the backdrop of the government's effort to move the economy up the value chain, one of the cornerstones of the 12th FYP. KPMG sees particularly the automobile and high-end equipment manufacturing industry as major beneficiaries of such ODI ventures.

[57] http://www.mckinsey.com/insights/asia-pacific/meet_the_chinese_consumer_of_2020

[58] The CIA World Factbook: "China" (data retrieved May 15th, 2014).

[59] The Economist: "FDI with Chinese characteristics", September 6th, 2012.

[60] MOFCOM

4.2 Investment flows from and to Switzerland

At present, around 600 Swiss firms with over 1000 branches are represented in China, employing several tens of thousands people. According to Chinese statistics, Swiss direct investments in China in 2010 amounted to 260 million USD, a decrease of 13% from 300 million USD in 2009. The cumulative Swiss investment in China grew to 878 million USD in 2012, leaving Switzerland on the 4th rank among European countries and 10th overall.[61]

The **figures on Swiss direct Investments in China published by the Swiss National Bank, differ significantly from the data released by the Ministry of Commerce** as shown by the fact that Swiss direct investments to China amounted to 1.6 billion CHF (1.75 bn USD) in 2012[62] (down from 5.33 bn CHF (5.67 bn USD[63]) in 2011), while the stock of Swiss direct investments stood at 14.81 billion CHF (16.21 bn USD) in the same year according to Swiss statistics.[64]

While the majority of the Swiss companies active in China are still located in the three Eastern economic centers Beijing/Tianjin, Yangtze-River Delta (Shanghai) and Pear-River Delta (Guangzhou, Hong Kong), a number of companies are also already located in the hinterland and inland provinces. Most represented are companies in the IT, Manufacturing, Food Stuffs and Chemicals & Pharmaceuticals industries.

The *CEIBS China Business Survey 2013-2014*[65] provides an updated view on the Swiss Business community in China. The survey found that **compared to 2013, sales and profits have slightly improved and Swiss companies tend to be more optimistic than a year ago**. The broader survey also including Chinese and other foreign companies reveals that the main challenges for doing business in China besides the economic slowdown remain HR related (finding and retaining talent and rising labor costs), followed by the fierce competitive environment and the legal environment. Innovation capability has newly emerged as an internal challenge, this being particularly the case for state-owned enterprises (SOEs). Besides, survey respondents mentioned a perceived reduction in corrupt government activities. Despite a growing tendency towards investments in China's southwest, the great majority of respondents still plans to invest in the coastal area.

So far, **Chinese direct investment in Switzerland is still modest** but started to increase significantly in the past years. As of today there are about 70 Chinese companies established in Switzerland.

While the Chinese investments appear to be scattered over most of Switzerland's larger economic centres (mainly within the Greater Zurich Area and the Greater Geneva and Berne Area), the reason for an investment in Switzerland is to acquire **technology** or a **brand** and making use of its existing **distribution network**. At the same time, the high education level and the central location seems to be of striking importance when choosing to set up a R&D centre or a European HQ in Switzerland. These investments generate employment, as around 90 percent of the staff is locally hired. Investments in the ICT and solar industries are to be mentioned in particular. Most Chinese companies present in Switzerland are of considerable size, whether private or state-owned. The acquisition of the trading firm Addax (based in Geneva) by Sinopec remains to date one of the most important Chinese investments in Europe.

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[61] MOFCOM

[62] 2013 data for Swiss FDI in China have not been obtained by the time the report was finalized.

[63] The currency conversion was done with Oanda Currency Converter, taking the 31.12. of both years 2012 and 2011 as conversion dates.

[64] *Data on FDI are always collected on two sides, in the country that places the direct investment and the country where the direct investment takes place. Since the institutions collecting the data in both countries cannot exchange information on investments due to reasons of confidentiality, the figures issued by different countries cannot be aligned and may therefore vary substantially as it is the case for Swiss and Chinese data on FDI.*

[65] A survey supported by Swiss Center, SwissCham Shanghai, Swissnex and China Integrated.

5 Trade, Economic and Touristic Promotion

5.1 Foreign economic promotion instruments

Given the market potential and the resulting increasing interest of the Swiss industry, it is not surprising that a growing number of Swiss institutions engage in activities facilitating market entry to and business in China, promoting the Swiss industry by various means. This goes in line with the conviction of the Swiss Federal Council, who considers it sensible to provide an effective commercial diplomacy for the Swiss economy.[66]

The **Embassy together with the three Consulate Generals in Shanghai, Guangzhou and Hong Kong**, as the official representations of Switzerland to China and the Hong Kong SAR, plays a pivotal role in ensuring a favorable environment for Swiss businesses interested or active in doing business in China and Hong Kong. Owing to a privileged access to the Chinese government institutions, the Embassy together with the respective Swiss Federal authorities engages in a number of government to government dialogues. At the moment, Switzerland is having such regular dialogues in the fields of Intellectual Property, Financial issues, Technical Barriers to Trade and Sanitary and Phytosanitary Measures etc.. Other cooperation activities resulting either from the Free Trade Agreement or other agreements further contribute to a preferential access to government institutions, providing a platform to bring problems of Swiss companies to the attention of the respective Chinese authority. Besides, the Embassy as well as all three Consulates engages in networking, high level promotional activities, company openings and the organization of economic delegations to China. Therefore, in facilitating and supporting negotiations on various agreements and various levels, the Embassy together with its regional outposts actively contributes to improving the framework conditions for bilateral trade and investment.

Within our diplomatic representations, the Swiss Business Hub is fully integrated into the operations of the Swiss Embassy and Consulate Generals. The **Swiss Business Hub China** as part of the worldwide “Switzerland Global Enterprise” network (formerly named OSEC) is operational in Beijing, Shanghai and Guangzhou. The specially trained Swiss and local SBH-staff offer services to Swiss SME in their endeavours of strengthening and developing their business relations with China (services include: market and product analyses; search of distributors, representatives and import partners; individual consulting and coaching; industry reports, presentations and trade fairs).

Since the beginning of 2009, the SBH assumes the mandate for investment promotion. The SBH China now also manages the promotion of Switzerland as a business location for potential Chinese investors. The aim is to inform and build on the firm Sino-Swiss relationships which have been established and raise awareness of Switzerland as a first-class business location for setting up regional and European headquarters among the Chinese business owners, entrepreneurs and investors.

Besides the Swiss Business Hub, the **cantons** as well as certain regional clusters have their own **investment promotion representatives**. The Swiss Business Hub, which carries out systematic market analysis and development has organised some high-level seminars, elaborated brochures, manuals and presentations and assists cantons and regions in their own endeavours in the very demanding Chinese market. With a number of recent Chinese investments in different parts of Switzerland the joint efforts of the SBH, the cantons as well as the service sector have already generated results. Like in other Asian countries, Switzerland is perceived as a prime location in the heart of Europe, but high living-costs and barriers for entry of Chinese workforce are on the flip-side.

[66] For more information on Switzerland’s position towards commercial diplomacy, please refer to The Foreign Economic Policy Report 2013.

The **Swiss-Chinese Chamber of Commerce** and the **SwissCham China** are private organisations registered in Switzerland and China respectively. Among their members are the leading Swiss companies in the trade, industry and financial sectors. The network consists of about 800 companies and individual members. Their purpose is to promote and support the global success of the Swiss business community in China.

Cleantech Switzerland is the official export platform for the Swiss Cleantech sector and was developed as one part of economic stabilization measures (2009) by Switzerland Global Enterprise. In China, the Swiss consulting firm Generis acts as the service partner of Cleantech Switzerland and as such provides services on site for Swiss companies in the field of environmental technologies.

In this regard, the **Sino-Swiss Zhenjiang Ecological Industry Park (SSZEIP)** has in 2013 received particular attention with a number of Swiss companies providing their know-how. The concept of a Sino-Swiss Eco-Industrial Park was first initiated in August 2010 by then Chinese Minister of Commerce Chen Deming and Swiss Federal Councillor for Economic Affairs Doris Leuthard with the objective to promote cooperation among companies from both sides in establishing an eco-friendly industrial park. On July 9th, 2012 a Memorandum of Understanding between the same Minister Chen and Swiss Federal Councillor Johann N. Schneider-Ammann on the Joint Establishment of the Sino-Swiss Zhenjiang Ecological Industry Park (SSZEIP) was signed. On July 10th, 2012 a Framework Agreement between Zhenjiang Economic and Technological Development Zone Administrative Committee (ZETDZ) and CTS followed to implement the project on operational level. On January 22nd 2013, the official Groundbreaking Ceremony took place and on **2nd July this year, the Park will be officially inaugurated by the Swiss State Secretary for Economic Affairs, Ms. Marie-Gabrielle Ineichen-Fleisch**. Key success elements so far include a building construction of 100’000 m2 gross floor area based on Swiss green building technology, CHF 5.5 Million contract volume for Swiss cleantech companies and CHF 50 Million FDI contract for Swiss companies locating in ZETDZ. According to the Chinese Ministry of Commerce, SSZEIP ranks number 1 amongst all similar bilateral projects with other countries.

In order to strengthen **bilateral cooperation in the field of higher education, research and innovation**, a **swissnex** office was opened in Shanghai in August 2008. swissnex China’s mission is to create and promote awareness of Swiss excellence in science, technology, innovation and culture, to connect academia and business and to facilitate cooperation between the two countries.

5.2 Interest for Switzerland as a location for tourism, education and other services, potential for development

The National Brands Index 2013 study revealed that **Switzerland ranks 5th for the Chinese in terms of national image**, behind Germany, the US, France and the UK. The perception of Switzerland seems to be better than the average of the 20 countries participating in the survey. While the governance system, the location for investment and work as well as the innovative products under the “Swiss made” label are considered as positive as among the occidental countries, the Swiss population and tourism are regarded even a bit more positively in China than in other countries. Switzerland’s perception with regards to culture and sport are rather weak. This is in line with the country’s perception in the other places surveyed.

Switzerland is also getting more attractive as a tourism location. The **one-million barrier for overnight stays by Chinese visitors in Swiss hotels could be surpassed for the first time in 2013.** Alongside France, Switzerland is the most sought-after European destination. By 2014, about 4.6 million Chinese will have the financial resources and the need for a trip to Europe. Of this number, Switzerland has potential for about 1.5 million Chinese. To a growing extent, our country is also becoming a destination for individual travellers, small groups and mono Swiss tours with longer stays and in-depth touring.

The demand for new Swiss routes and tourism products (destinations, experiences) is also picking up. The biometric Schengen visas are likely to be introduced in 2015. The application centers of the outsourcing partner in Beijing, Shanghai and Guangzhou are technically prepared for the introduction of the biometric processes early 2015. However, application centers in other locations throughout China need to be opened in future in order to cope with the growing large numbers of visa applicants.

The **Swiss public education sector and its institutions have become increasingly attractive among Chinese students.** Despite the fact that Switzerland is mostly known for its hotel management education and that it is considered as one of the most expensive countries, the number of Chinese students in Switzerland has been growing steadily. In 2012/3 there were 1'228 Chinese nationals enrolled in Swiss education institutions.[67] The good positions of our institutions in various rankings and the fact that more and more programmes on the Master level are taught in English contribute to this growing interest in China. The Swiss representations are actively involved in promoting Swiss education opportunities throughout China. Identification and selection of the top students is increasingly becoming the main challenge.

5.3 Interest for Switzerland as a location for investment, potential for development

A large majority of decision makers and business people have a very good perception of Switzerland as a tourism destination. Most of them, however, have **little idea of what Switzerland could offer them as a place for doing business.** Nonetheless, awareness has been increasing since Premier Li Keqiang's visit to Switzerland in May 2013 and the signature of the FTA in July the same year. Therefore, a lot of awareness building has to be done as the image of Switzerland is still dominated by chocolate, watches and nice landscape. Nevertheless, those clichés give a rather positive image about Switzerland which should not be neglected.

Chinese entrepreneurs and companies do **not always make decisions purely based on business rationale,** and currently predominantly focus on investments which are still largely based on M&A in terms of value (in Europe only for the year 2011 USD 1.22 billion were invested in 54 greenfield projects vs. USD 8.59 billion in 37 M&A) with a focus on the biggest markets (Germany, France and the UK). The main reason for this trend might be the fact that M&A remains the quickest and easiest way to step foot overseas. In such manner, they can acquire brands, technologies and knowledge in order to apply them to the Chinese market where growth is still substantially higher than in Europe. Besides, Chinese investors will rather choose a country or region where they have existing business relationships (e.g. traders, distributors, etc) and where a certain number of Chinese citizens are already present. These soft factors are important in the decision making process of the first overseas investment and as a consequence the perception of Switzerland as a business place might suffer because of its small size and rather constrained Chinese community. However, **Switzerland becomes of interest as a business hub (HQ, operational center) once a first settlement was made and when the company seeks to develop and structure its European activities.**

Swiss Cantons and regional associations are in negotiation with a number of Chinese companies, so Chinese companies in Switzerland could increase in the coming months and years. Generally, the Chinese presence is growing faster in Europe than in other continents because of less protectionist measures than in places like the US or Australia.

5.4 Interest for Switzerland as a financial location, potential for development

Chinas is catching up in positioning its RMB as internationally used currency and steadily increases its place on the SWIFT list of most-used payment currencies worldwide. While in December the RMB was on place 8, it surpassed the Swiss franc in January and got on place 7 of the SWIFT list. The use of the RMB increased by 30,6% alone in January while the growth of

[67] Bundesamt für Statistik

all the payment currencies was at 4,8%. **While the absolute market share of the RMB is still relatively low with 1,39%, in relative terms the RMB has managed to get a fix place in the top ten of the internationally used currencies.** The RMB payments are concentrated in Hong Kong with 73% share, followed by the UK, Singapore, Taiwan, the United States, France and Australia.

During 2013, China focused on concluding more SWAP-Agreements reaching 23 of them with an overall value of RMB 2,6 trillion (USD 427 billion, 2014 seems to be dedicated to identify RMB clearing banks. Since July 2013 the **Bank of China in Luxembourg is the first clearing bank in Europe**. On the occasion of President XI's visit in Europe, the PBoC concluded with the German Federal Bank as well as with the Bank of England an agreement on future clearing out of these financial centres.

Switzerland is also interested in becoming a RMB-hub, however in comparison with the other European financial centres there is no SWAP-Agreement in place and no Chinese bank settled in Switzerland yet that could once take over the RMB-clearing.

At the end of June this year, the second Financial Dialogue will take place in Switzerland. The occasion will be used to hold **the first Chinese-Swiss Financial Round Table** on the 27th of June with leaders from the Chinese and Swiss financial sector, from governments, central banks and regulators. Federal Councillor Eveline Widmer-Schlumpf will open the Round Table.